



Low-End/High-End Residential Property Assessment

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Today's Agenda

- Overview
 - Identifying High-End and Low-End Residential Properties
 - Assessment Issues
- Assessment Strategies
 - Sales Validation
 - Foreclosures
 - Re-sales
 - Outlier Identification
 - Calculating Local Adjustment Factors
 - Construction Quality Factor (Grade)
 - Depreciation Schedule



Low-End Residential Property

- Normally considered of low value
- Often in poor or distressed location
 - Economically poor
 - Contaminated or otherwise undesirable
- Often in poor condition
 - Curable/incurable deterioration
 - Highest and Best Use may be as vacant
- Opinions may vary. . .
...but “you know it when you see it.”



Low-End Residential Property Examples

Grade D Dwelling from 2011 Real Property Guidelines





Low-End Residential Property Examples

Grade E Dwelling from 2011 Real Property Guidelines





Low-End Residential Property Examples

Low End Property with Curable Deferred Maintenance





Low-End Residential Property Examples

Interior of Low End Property with Incurable Deterioration





Low-End Residential Property Examples

Interior of Low End Property with Incurable Functional Obsolescence





Assessment Issues with Low-End Property

- Cost approach difficult to implement
 - Physical Deterioration
 - Curable (Deferred Maintenance): Must estimate cost to cure.
 - Incurable: Cost to cure greater than economic benefit.
 - Functional obsolescence
 - Incurable: Property has no bedroom.
 - Curable: Property has no air conditioning.
 - External (Economic) Obsolescence
 - Ex. Property situated next to sawmill.
 - Usually incurable.
- Estimating these value components can be difficult.



Assessment Issues with Low-End Property

- Highest and Best Use may be as vacant
 - Incurable defects
 - Changing market
 - Sale price may reflect this. . .
...but Indiana requires assessment at Market Value-In-Use.
- Sales often have special circumstances
 - Foreclosure
 - Remodel and Resell (“Flipping”)
 - Institutional buyers/sellers
- Both of these create challenges for sales validation.



High-End Residential Property

- Normally considered unique, unusual, or extraordinary for local market.
- Often in very good location.
- Opinions may vary. . .
...but (as with low-end property), “you know it when you see it.”



High-End Residential Property Example

Grade AA dwelling from 2011 Real Property Guidelines





High-End Residential Property Example

Grade AA dwelling from 2011 Real Property Guidelines





High-End Residential Property Example

A high-end residential property in Calabasas, CA. . .





High-End Residential Property Example

...belonging to a well-known entertainer.





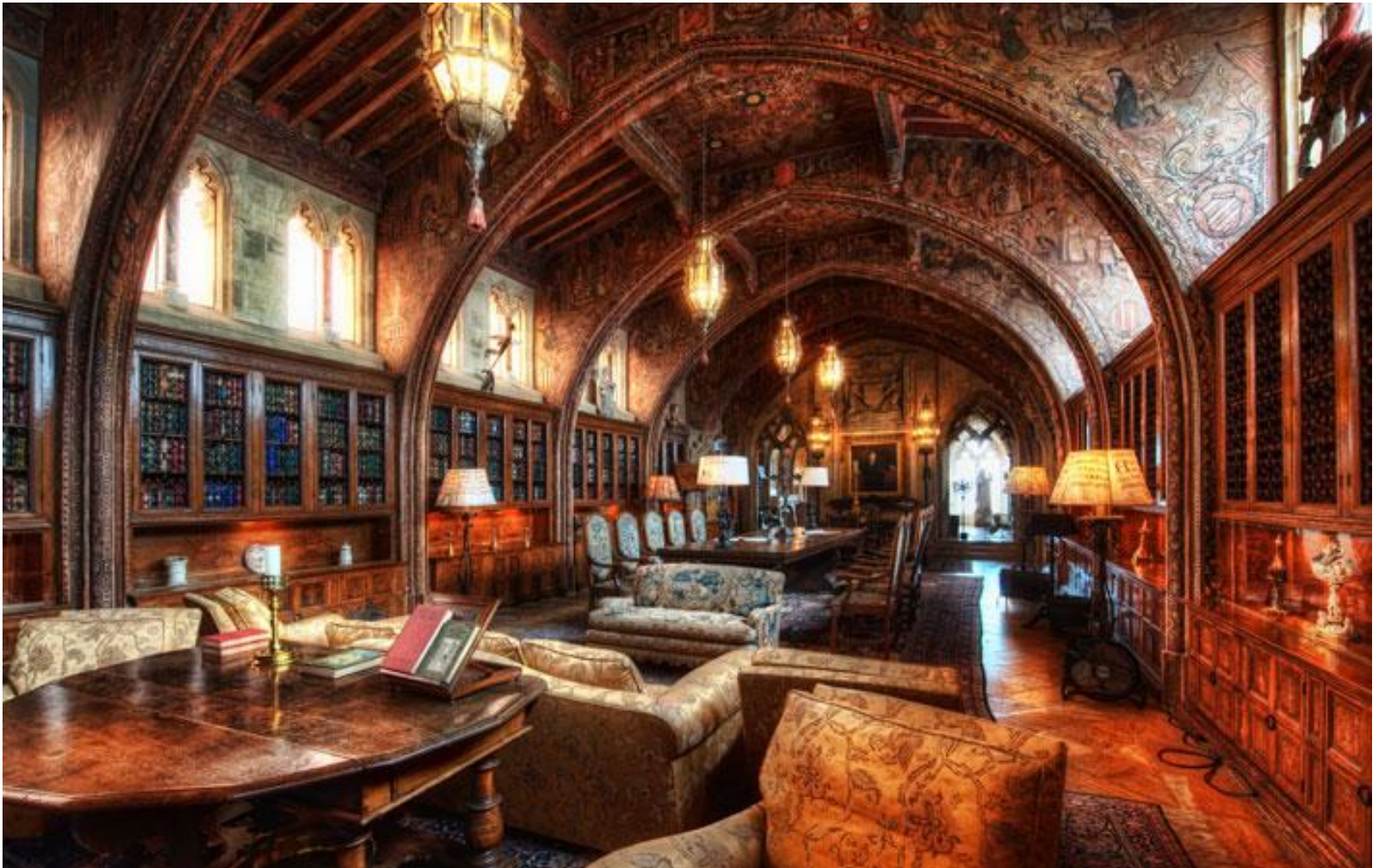
High-End Residential Property Example

Some properties are high-end in any neighborhood. . .





High-End Residential Property Example





High-End Residential Property Example





High-End Residential Property Example

...while others are high-end relative to their neighborhood.





Assessment Issues with High-End Property

- Property often tailored to owner's taste:
 - May be overbuilt for market.
 - May have significant functional obsolescence due to unique design choices.
- Cost schedules based on typical properties.
 - Grade adjustment may not be accurate for local conditions.
 - May depreciate differently than typical properties:
 - Unique design elements.
 - Continuous maintenance.



Assessment Issues with High-End Property

- Highest and best use may be as vacant if:
 - Location is excellent.
 - Supply of land is scarce.
 - Potential buyer likely to demolish and rebuild.
- Sale prices may reflect this. . .
...but Indiana requires assessment at Market Value-In-Use.



Assessment Strategies

- Sales Validation
 - Selecting valid sales
 - Handling foreclosures
 - Handling remodel and resales (“flips”)
- Outlier ID and Trimming
 - Identification
 - Causes and Solutions
 - Reporting to Department
- Local Adjustment Schedules
 - Adjusting Grade for Local Markets
 - Adjusting Depreciation for Local Markets



Sales Validation

- Sales validation can identify special circumstances:
 - Low-end properties
 - Foreclosure
 - Remodel and Resale (“Flipping”)
 - Material damage
 - Otherwise distressed
 - High-end properties
 - Additional improvements
 - Interior construction quality
 - Personal property
- Proper validation can tell you:
 - Is sale representative of market?
 - If so, what market?



Sales Validation

- Requirements for all sales
 - Valuable consideration
 - Almost always money
 - Excludes transfers solely for legal purposes
 - Arm's length transaction
 - Competitive, open market
 - Willing buyer and seller
 - No coercion or duress
- Sale price should indicate market value
 - Judgment call
 - We'll discuss what to do when it doesn't



Type of Unsuitable Sales

- Buyer/seller relationship
- Multi-parcel sales
- Non-warranty deeds
- Special circumstances:
 - Partial interest
 - Land contract
 - Atypical financing



Foreclosure Sales

- Low-End properties may be in foreclosure.
- Foreclosure defined:
 - “A legal proceeding to terminate a mortgagor’s interest in property, instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the property (IAAO 2009).”
- Key questions to ask:
 - Is the sale price typical of other properties?
 - Are there a large number of these sales relative to other sales in the area?



Foreclosure Sales

- The Indiana foreclosure process:
 - Borrower fails to make required mortgage payments.
 - Bank places borrower in default.
 - Property is legally transferred to bank (foreclosure).
 - Bank resells property with realtor or at auction.
- Property can be sold during any one of these steps:
 - Pre-foreclosure sale
 - Foreclosure sale
 - Post-foreclosure sale



Pre-Foreclosure Sales

- Pre-foreclosure sales: Made by property owner in default to avoid foreclosure.
 - Regular third-party sale
 - Sale by owner to third-party for amount owed or more.
 - Short sale
 - Sales by owner to third party for less than amount owed
 - Requires bank approval.
- In both cases:
 - Seller is pressured by threat of foreclosure.
 - Buyer often has bargaining power not typical of market.



Foreclosure Transfers

- Foreclosure transfer
 - Legal transfer of deed from owner to bank to avoid foreclosure.
 - Sale price will be outstanding loan amount.
 - Requires sales disclosure, but **NOT** a sale.
- Deed in lieu
 - Surrender of deed from owner to bank to avoid foreclosure.
 - Essentially a foreclosure.
- These are not valid sales
 - Sale is under duress.
 - Sale price based solely on outstanding loan amount.



Post-Foreclosure Sales

- Sheriff's Sales
 - Sale by county sheriff of foreclosed property at public auction.
 - Bank always bids minimum to protect investment.
 - May sell to bank or third-party.
- Guidelines for validation
 - If sold to bank, don't use.
 - If sold to third-party, treat as normal sale at auction.
 - Auction well-advertised and attended.
 - Only use if sale price is comparable to other properties.



Post-Foreclosure Sales

- Resales
 - Sale of foreclosed property purchased at auction.
 - May be sold by bank or by third-party.
 - May sell several properties as lots or at auction.
- Guidelines for Validation
 - Sales of lots / auctions are invalid.
 - Other sales by bank should only be used if sale price is comparable.
 - Other sales by third-party may be used if otherwise arm's length transaction.



Remodel and Resell

- Low-End properties may be bought, remodeled, and resold for profit (“flipping”).
- Two questions:
 - Should flipped properties be used to set values?
 - How should parcel characteristics be updated?
- Setting values:
 - Only use second sale (the “flip”).
 - Validate sales conditions like any other sale.
 - May exclude if evidence of mortgage fraud, or other unusual circumstances.



Remodel and Resell

- Update new construction
- Updating effective age
 - OK if effective age is substantially different than actual age.
 - Use standardized method.
 - Preferable than updating condition on older properties.
- Updating grades
 - Uniformly: Properties with similar remodeling should have same grade.
 - Use standardized method and document updates.
 - Develop criteria for each grade.
 - Example: “In neighborhood ABC, 7 parcels were remodeled and then resold. Each parcel has new plumbing fixtures, carpet, kitchen cabinets, and interior paint. Because of this, the grade on each parcel was updated from C to C+1.”



Outliers

- “Observations that have unusual values, that is, they differ markedly from a measure of central tendency.”*
- Example Sales Ratio Outliers:
 - **0.30 Much less than median**
 - 0.82
 - 0.95 Median ratio
 - 1.03
 - **2.15 Much more than median**
- Found with both High and Low End Properties
 - High-end properties are often unusual, and attract affluent buyers.
 - Low-end properties may be distressed, and attract speculators (flippers) and mortgage fraud.

*IAAO Glossary for Property Appraisal and Assessment (1997)



Outliers

- Outliers may indicate
 - Data errors
 - Unknown/unusual circumstances
- Examples:
 - 1,500 SF ranch sells for \$100,000; square footage listed as 150 SF.
 - Data error leads to very low AV.
 - Ratio will be much lower than others.
 - Same property sells for \$10,000; sale from father to son (this is not known).
 - Unknown circumstances leads to very low sale price.
 - Ratio will be much higher than others.



Outliers

- Ex. 3: Same property sells for \$300,000; looks just like any other valid sale.
 - Unusual circumstances might have caused buyer to overpay:
 - Buyer is so rich, he doesn't care what he pays.
 - Seller and buyer are trying to commit fraud.
 - Sunspots, Friday the 13, ?????
 - Ratio is much lower than others.
- In all 3 cases, you will have a ratio that is much lower or much higher than the median ratio.
 - Can shift median, leading to inaccurate trending.
 - Can make COD/PRD out of tolerance.
- In these cases, you can identify outliers and exclude them from the ratio study.



Outlier Identification

- Outlier identification:
 - Common sense.
 - Statistical methods.
- Common sense
 - Review ratios between 0.25 and 2.0.
 - Often caused by data errors or invalid sale.
- Statistical methods
 - Appendix B of 2007 *IAAO Standard on Ratio Studies*.
 - Other methods supported by sound evidence.
 - May **NOT** just exclude “too high” or “too low” ratios.



Outlier Identification

- Appendix B method
 - Array ratios from low to high
 - Calculate first quartile (1Q) and third quartile (3Q)
 - 1Q: Ratio halfway between smallest ratio and median
 - 3Q: Ratio halfway between median and largest ratio
 - Subtract $3Q - 1Q$ to get interquartile range (IQR)
 - Establish lower and upper boundaries*:
 - Lower boundary: $1Q - 1.5 * IQR$
 - Upper boundary: $3Q + 1.5 * IQR$
- Described in attached handout
- Easiest to do in Excel
- * May also use $1.5 * IQR$ if ratios are clustered near median.



Outlier Reporting

- Handling Outliers
 - Check for data error
 - Try to confirm cause
 - If cannot confirm, ok to exclude
- Reporting Outliers
 - All excluded outliers must be reported
 - Easiest to include worksheet with ratio study
 - Sale information
 - Sales ratio
 - Calculation details



Local Grade Analysis

- Existing grade schedule (Schedule F) may not accurately estimate Low-End and High-End properties for your county.
- You can develop a local grade schedule for your county based on builder cost or sales data.
 - Calculate local costs for different grade properties.
 - Compare to Department costs.
 - Adjust as necessary.



Local Grade Analysis

- Sales data can be used if builder cost data is not available.
 - Select typical sales for each grade.
 - Subtract land value from sale price.
 - Divide result by square footage to get SF rate for each grade.
 - Compare average SF rates with one another and with Department costs.



Local Depreciation Analysis

- Low-end and high-end properties may also depreciate differently than typical properties.
 - Atypical maintenance
 - Low-end: deferred maintenance
 - High-end: “pro-active” maintenance
 - Buyers less concerned about depreciation
 - Low-end: “Flippers” will remodel property anyway.
 - High-end
 - Cost to remedy less a concern.
 - May plan to customize property.
- Customized depreciation schedules may help capture these differences.



Calculating Depreciation in Excel

- Select typical sales.
- Subtract land value from sale price.
- Divide result by Replacement Cost New (RCN) to get Percent Good.
- $\text{Depreciation} = 1 - \text{Percent Good}$.
- Plot **Age** vs. **Depreciation** in Excel.



Calculating Depreciation in Excel

- Insert scatter plot of Age vs. Depreciation.
 - Insert | Scatter
- Add trend line
 - Right-click on plot, then select Add Trendline.
 - Check Display Equation on Chart.
- Use equation to calculate depreciation schedule.
- Caution: Be sure straight line fits data well.
 - Look at plot: does it seem to fit?
 - $R^2 > 0.6$ (higher is better).



Notes on Calculating Depreciation

- Requires accurate sales validation.
- Requires accurate land values.
 - Check land-to-building ratio.
- Use Average condition and typical grade property.
- Check if stratification has impact.
 - One story vs. two story
 - Frame vs. brick



Questions?



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